BNZ Weekly Overview

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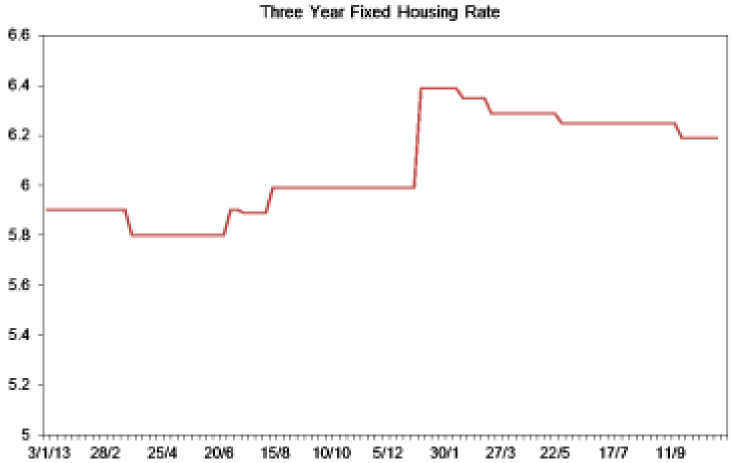
Mission Statement

To help Kiwi businesspeople and householders make informed financial decisions by discussing the economy and its implications in a language they can understand.

If I Were A Borrower What Would I Do?

Hopefully borrowers were quick enough to grab the special BNZ three year fixed rate of 5.85% introduced for a short one week period over the long weekend. That is quite a discount from the normal 6.19% rate and only just above the current two year rate of 5.75%.



As noted here previously and taking into account the new wave of change in interest rate forecasts sweeping across the globe, were I borrowing at the moment I would look for a good discounted rate in the two or three year area. With the standard four year rate at 6.79%, even were a special rate introduced it would probably not be low enough for me to grab it.

Recent big changes in interest rate forecasts around the world driven by data showing lower than expected growth, falling inflation, and therefore surging worries about deflation, serve to remind us that post-GFC the world is not in a very predictable state. For four years now in this section we have explicitly written that you should not develop an interest rate hedging strategy which is dependent upon a particular set of interest rate forecasts proving accurate. These forecasts have been changed many times these past few years, more changes are certain, and no-one can say that they have been correctly calling things since 2009, or 2008, or 2007 for that matter.

In fact over the past three months we have shifted our forecast for when the RB might raise the official cash rate again from December 2014 to March 2015, then September 2015, and now we think December 2015, or 2016, or not at all. That is because this morning the RB released a far more dovish than expected review of the OCR and removed their previous reference to the need for further tightening at some stage. Now, after noting the recent low inflation outcomes, weakening growth offshore, falling petrol prices, easing housing market, and subdued wage inflation they have written “A period of assessment remains appropriate before considering further policy adjustment.” In other words they have opened up the possibility of no further rate rises this cycle.

Seek to get yourself a mixture of floating and fixed rate terms which reflect the high level of uncertainty which persists about inflationary pressures here and overseas, be careful about the debt you take on, and work hard by sacrificing current consumption in order to get your debt down to comfortable levels as soon as possible.

	This week	Week ago	4 wks ago	3 mths ago	Year ago
Official Cash Rate	3.50	3.50	3.50	3.50	2.50
90-day bank bill	3.70	3.70	3.73	3.73	2.69
1 year swap	3.76	3.84	3.91	3.91	3.02
2 year swap	3.91	4.03	4.14	4.11	3.47
3 year swap	4.05	4.15	4.28	4.29	3.83
4 year swap	4.14	4.23	4.36	4.39	4.10
5 year swap	4.22	4.29	4.43	4.49	4.32
7 year swap	4.34	4.39	4.53	4.62	4.63
10 year swap	4.46	4.49	4.63	4.79	4.88

As a reminder because people continue to ask, I do not have a section here looking at what I would do were I an investor. That is because whereas most borrowers are the same, all investors are unique. They have different levels of understanding of financial and other products, different levels of risk tolerance, different sources of cash inflow, varying assets, varying times for when funds will be required, and so on. The emotions involved in investing are also a lot more raw than those involved in borrowing, and because the average person ends up finding investing to be a stressful exercise they can too quickly seek more to have the problem taken away from them than to sensibly consider the range of alternatives facing them.

Thus their brain kicks into stress reduction mode which often means finding the first person who they can trust and who appears to know what they are talking about and following their recommendations. Hence the huge amounts of money whacked into finance companies by older people in the 1990s and 2000s probably in response to the nice people who took part in company marketing.

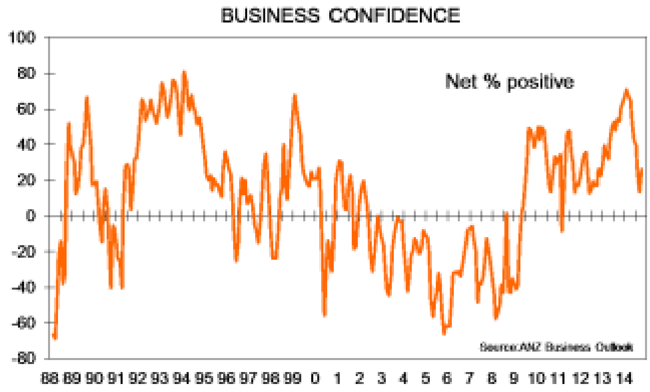
Just going back to the deflation worries comment just above. In Sweden in 2010 and 2011 the central bank raised interest rates to 2% because of worries about the housing market even though the economy was not that strong and unemployment was high. Now, having seen monthly inflation numbers falling for 16 of the past 24 months they have just cut their overnight cash rate to 0% because they, like more and more people in the Eurozone, are deeply worried about deflation., Who would have thought it? Since the 1970s the focus for all of us with regard to monetary policy (excluding Japan from 1990 or so), has been making sure inflation does not start getting away on us. Now the worry instead is deflation.

This poses a big problem for central banks because unlike raising interest rates to crush inflation, cutting them to fight deflation fails once rates are zero. At that stage some version of money printing has to be embraced, which is where the Eurozone is at right now, the US was for six years, where Japan is, and where Sweden might be soon also. One can usually take a reasonable stab at the impact of interest rates changing. But when it comes to printing money all bets are off because you cannot know by how much more banks will become willing to lend, or by how much more people will become willing to borrow, or to what extent one might create worrying asset price bubbles for the likes of housing.

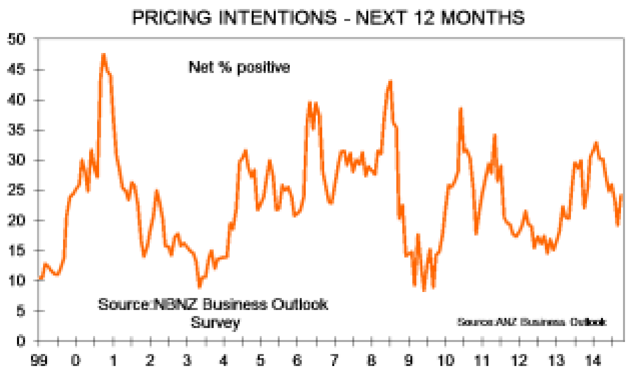
Which then takes one to the horror scenario. This involves intractable deflation, yet printed money boosting house prices which cannot be fought using interest rates. Instead central banks must experiment with credit controls of funds flowing into the housing market. That is the solid path which central banks are now on and the new deflation worries boost the chances of more quantitative controls – including here in New Zealand.

We do not face deflation, but at just 1% inflation is at risk of breaching the bottom end of the Reserve Bank's target range. Imagine the warnings they would be delivering were inflation 3%. Yet there are no warnings of interest rates being cut now that we are at the other end of the target range. Why? Two reasons.

Firstly, there is a reasonable chance that the rate of inflation will move back to the middle of the target range as booming construction activity and a tightening labour market boost inflationary pressures. This week for instance the monthly ANZ Business Outlook survey recorded a strong post-election bounce in business confidence to a net 27% optimistic from 13% in September – a two year low. Employment intentions are at a well above 6% average at a net 19% positive. Good jobs growth is likely to continue. A net 16% of businesses plan raising their capital spending, reasonably well though not hugely above the ten year average of a net 9%.



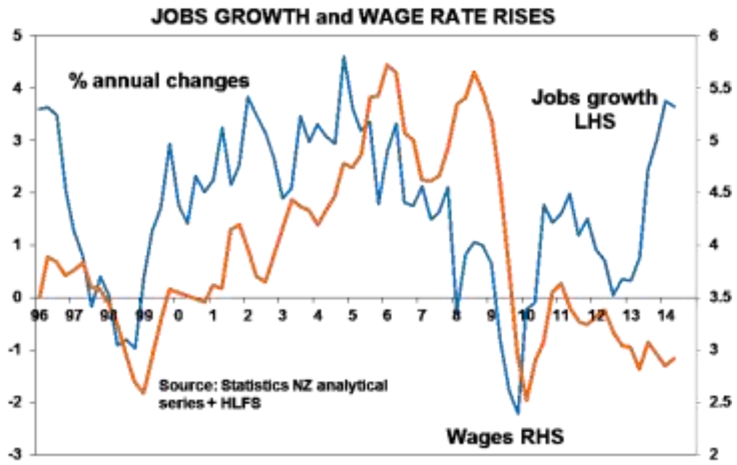
The survey shows that a net 24% of businesses plan raising their selling prices over the coming year which is bang on the long-term average. However this reading plus the 19% last month and 23% reading in August sits down from rates over 30% from November to April – outcomes which helped produce the recent low CPI result. Thus the latest net 24% pricing intentions result while equal to average, is not suggestive of the 3% inflation band being threatened anytime soon.



Second, any signals of falling interest rates now from the RB could give extra strength to the housing market and the RB remain concerned about high house prices.

However, so far all our forecasts of rising inflation due to above trend economic growth have proved wrong. We are over-forecasting inflation in the post-GFC world – a tendency also displayed offshore. Little inflation anywhere is coming from labour markets as employees focus largely on job retention rather than remuneration growth. Businesses also don't appear to feel that they have good pricing power – an ability to raise prices and have little negative reaction from customers. Key inflation drivers are broken.

This following graph shows as the blue line the year ago rate of change in employment in New Zealand, measured on the left side axis. Wages growth measured by a wages index specially created by Statistics NZ to try and track unchanging jobs is shown as the orange line. History suggests to us that the orange line should be rising by now. It isn't. It will, but we don't know when and the current surge in extra employees courtesy of the immigration binge means it could take even longer than usual for the wages growth acceleration to start.



Yet the housing markets in our two biggest cities remain firm with shortages worsening in Auckland in particular and investors likely to be feeling that buying and holding is a no-brainer given the abject failure so far of central and local government in boosting construction to any great degree.

Thus these housing markets are likely to remain firm – especially as mortgage rates are now falling – for fixed rate borrowing. The impact of the Reserve Bank raising the official cash rate from 2.5% to 3.5% between March and July this year is being undone by deflation worries offshore causing newly falling medium to long-term borrowing costs. In March when the cash rate was 2.5% and floating mortgage rates 5.74% the three year fixed housing rate was 6.35%. Our special rate was just 5.85% and history tells us such specials are often copied and or repeated. So cash rate up 1%, the key fixed rate down 0.5%.

We have been here before and we know it means that borrowers move from floating to fixed rates – something which as an aside cuts bank profits because of the lower margins on fixed rather than floating rates and thus causes extra bank pushes for higher product sales plus cost savings.

So what are the implications of all this for monetary policy? As noted above, NZ inflationary pressures in aggregate do not look like providing a reasonable basis for any further increase in the official cash rate until December next year, if at all. Yet the need to restrain housing remains. The chances of the loan to value ratio rules being relaxed in the next year or two are low. The chances of further restrictions being introduced are growing. Meaning? Same as what we have been saying since the middle of 2009. The incentive is to move early to buy (borrow and buy) a property rather than to wait.

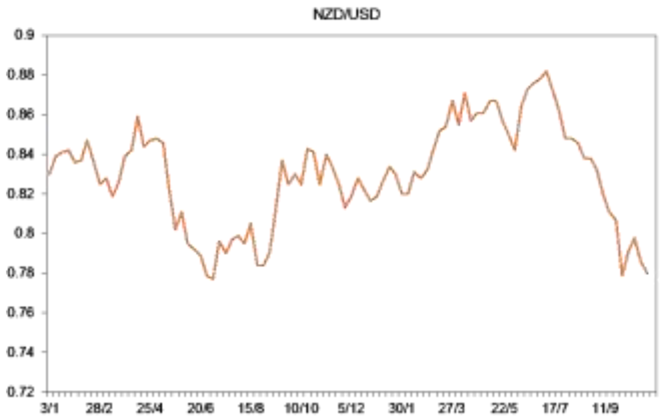
And outside Auckland and Christchurch? Well that all depends upon whether people start cashing up in those centres and freeing up funds by shifting elsewhere, and whether investors do what they did in the 2000s and start seeking better yields outside Auckland.

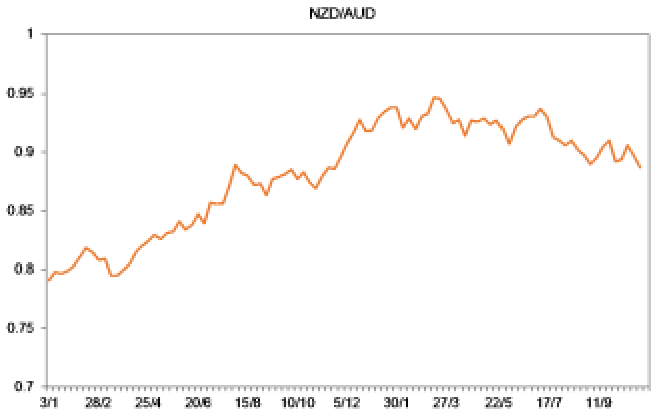
FX

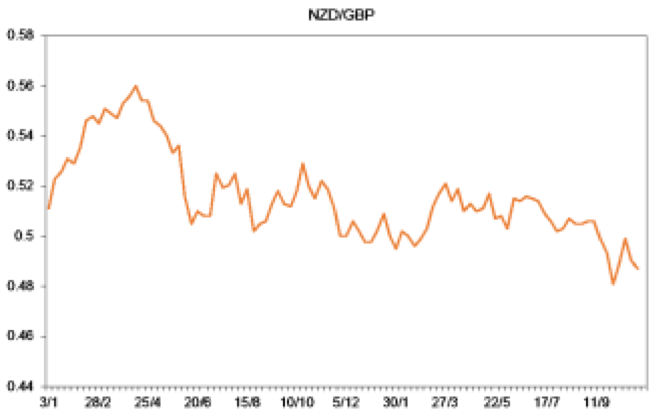
The NZD has fallen from where it was a week ago mainly in response to the dovish cash rate review this morning from the Reserve Bank and their repeated statement regarding expecting further substantial depreciation in the NZD from "...unjustified and unsustainable..." levels. We are trading this evening against the USD near 78 cents from 78.6 cents a week ago and have declined against most other currencies excluding the Yen against which we have risen slightly with deepening worries about Japan's growth prospects causing some weakness there.

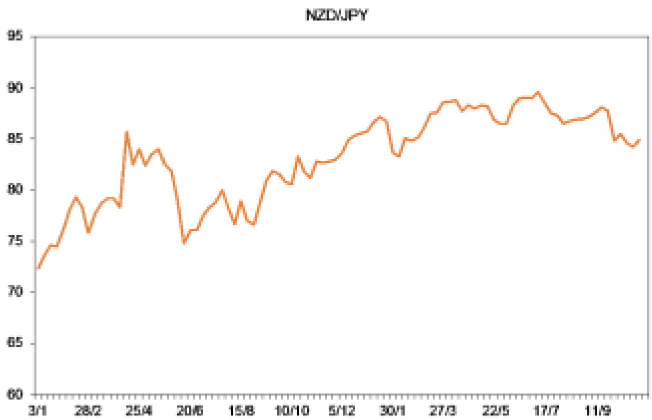
In the UK some fresh dovish signals came from some senior Bank of England people so the markets have continued their process of pushing out in time the expected occurrence of the first monetary policy tightening. In similar vein in the United States, although a reading for consumer confidence jumped surprisingly strongly this month, orders for durable goods - considered an early indicator of business investment – turned out weaker than expected in September. Plus house prices continue to pull back anew. Thus monetary policy expectations in the US have also been pushed out just a little bit further.

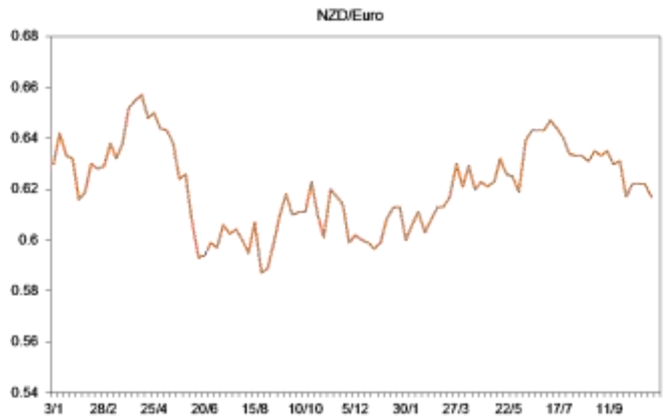
	This Week	Week Ago	4 Weeks Ago	3 Months Ago	Year Ago
NZD/USD	0.78	0.786	0.779	0.848	0.825
NZD/AUD	0.887	0.897	0.892	0.91	0.869
NZD/JPY	84.9	84.2	84.8	87.3	81.2
NZD/GBP	0.487	0.49	0.481	0.502	0.515
NZD/EUR	0.617	0.622	0.617	0.634	0.601
NZD/CNY	4.77	4.81	4.78	5.24	5.03
USD/JPY	108.85	107.12	108.86	102.95	98.42
GBP/USD	1.60	1.60	1.62	1.69	1.60
USD/EUR	1.26	1.26	1.26	1.34	1.37
AUD/USD	0.88	0.88	0.87	0.93	0.95
USD/CNY	6.113	6.12	6.1385	6.1741	6.0946











The Weekly Overview is written by Tony Alexander, Chief Economist at the Bank of New Zealand. The views expressed are my own and do not purport to represent the views of the BNZ. To receive the Weekly Overview each Thursday night please sign up at www.tonyalexander.co.nz To change your address or unsubscribe please click the link at the bottom of your email. Tony.alexander@bnz.co.nz